(1) (10)

Nos. 87-453 and 87-464

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

AMERADA HESS CORPORATION, *et al.*,
Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
Appellee.

TEXACO INC. and TENNECO OIL COMPANY,
Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,
Appellee.

On Appeals from the Supreme Court of New Jersey

BRIEF OF THE AMERICAN MINING CONGRESS AND THE NATURAL GAS SUPPLY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF APPELLANTS

WILLIAM L. GOLDMAN*
JAMES A. RIEDY
LEE, TOOMEY & KENT
1200-18th Street, N.W.
Washington, D.C. 20036
(202) 457-8500

**Counsel of Record*

PRESS OF BYRON S. ADAMS, WASHINGTON, D.C. (202) 347-8203

20 pp

QUESTION PRESENTED

Whether the Due Process, Commerce, and Equal Protection Clauses of the United States Constitution permit a State, in defining the apportionable income of a multistate unitary business, to include income contributed by an exclusively out-of-state business activity but to exclude associated costs incurred solely on account of that activity.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

No. 87-453

AMERADA HESS CORPORATION, *et al.*,
Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
Appellee.

No. 87-464

TEXACO INC. and TENNECO OIL COMPANY,
Appellants,

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,
Appellee.

ON APPEALS FROM THE SUPREME COURT OF NEW JERSEY

BRIEF OF THE AMERICAN MINING CONGRESS AND THE NATURAL GAS SUPPLY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF APPELLANTS

INTRODUCTORY STATEMENT

This brief is submitted by the American Mining Congress and the Natural Gas Supply Association as *amici curiae* in support of the appellants in the above-captioned cases. Written consents of the appellants and the appellee have been obtained and filed with the Clerk of the Court.

INTEREST OF AMICI CURIAE

The American Mining Congress is a nonprofit association of approximately 450 companies that produce a major portion of the Nation's minerals, including coal, metals, and nonmetallic industrial and agricultural minerals. The Natural Gas Supply Association is a nonprofit association of approximately 75 companies that produce and market nearly 90% of the Nation's natural gas. Some of the appellants in this case or their subsidiaries are members of the *amici*.

This case is important to the members of these associations because of the potential impact that the decision of the New Jersey Supreme Court may have on the state tax treatment of costs similar to the Federal Windfall Profit Tax ("WPT"), particularly state severance taxes. In 1984, for example, United States mining and oil and gas companies, most of whom are represented by the *amici*, collectively paid over $7,000,000,000 in state severance taxes. Because deposits of hydrocarbons and hard minerals are concentrated in a limited number of States, approximately 80% of the foregoing 1984 severance tax payments were paid to only six States.[1] On the other hand, there are at least 30 States that impose no significant severance taxes.[2] The *amici* are concerned that, if the decision below is affirmed, other States will similarly seek larger tax revenues by disallowing deductions, in computing apportionable income for formulary apportionment purposes, for costs that are incurred solely in connection with out-of-state production activities.

SUMMARY OF ARGUMENT

The underlying issue in this case is to determine the portion of appellants' unitary business income that is attributable to their marketing, refining, and other non-production oil activities in New Jersey. That is all New Jersey may constitutionally tax.

New Jersey purports to use the traditional three-factor formulary apportionment method for this purpose. In fact, New Jersey's approach to determining appellants' apportionable income is inconsistent with the underlying rationale and justification for formulary apportionment. New Jersey seeks to increase the amount of appellants' income apportioned to New Jersey under the apportionment formula by artificially increasing the amount of apportionable income de-

[1] In 1984, the States collected $7,248,943,000 in severance taxes. Of that amount, Alaska, Texas, Oklahoma, Louisiana, New Mexico and Wyoming collected approximately 80%. *Facts and Figures on Government Finance* e24-e25 (Tax Foundation, Inc. 23rd ed. 1986).

[2] As of 1984, 18 States (including New Jersey) had no severance tax revenues, and 12 other States had severance tax revenues of less than $10,000,000. *Ibid.*

rived from their out-of-state production activities. This is accomplished by disallowing a deduction for a production cost—the WPT—that is incurred solely on account of those out-of-state activities.

In substance, the State is including in the appellants' apportionable income the *gross* revenue derived from the out-of-state production activities without deductions for all associated costs (oil production income with no WPT deduction) and the *net* income derived from New Jersey activities (refining, marketing, and other non-production oil activities with deductions for all associated costs). Such a hybrid definition of apportionable income necessarily means that New Jersey is taxing extraterritorial values in violation of the Due Process and Commerce Clauses of the Constitution.

Moreover, by denying out-of-state producers a deduction for certain costs that are effectively deductible by competitors who purchase rather than produce their crude oil or refined products, New Jersey also impermissibly burdens interstate commerce in violation of the Commerce and Equal Protection Clauses of the Constitution.

ARGUMENT

I. NEW JERSEY'S INCLUSION OF INCOME FROM APPELLANTS' OUT-OF-STATE PRODUCTION ACTIVITIES IN THE APPORTIONABLE INCOME OF THEIR UNITARY OIL BUSINESSES WITHOUT ALLOWING A DEDUCTION FOR WPT, A COST INCURRED SOLELY ON ACCOUNT OF THOSE PRODUCTION ACTIVITIES, VIOLATES THE DUE PROCESS AND COMMERCE CLAUSES.

A. The Rationale for Formulary Apportionment.

Under both the Due Process and the Commerce Clauses, a State may tax a corporation only on that portion of the corporation's income that is attributable to the corporation's activities in the taxing State. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983). The State may not tax "extraterritorial values" (*Butler Bros. v. McColgan*, 315 U.S. 501, 507 (1942)) or "tax value earned outside its borders" (*ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)).

In this case, as the New Jersey Supreme Court noted (J.S. App. 2a),[3] appellants are vertically integrated oil companies engaged in all phases of the oil business, including exploration, production, refining, manufacturing, and marketing. Appellants engage in business both within and without New Jersey. All of appellants' production activities occur outside New Jersey. Their only New Jersey activities are limited to refining, marketing, and other non-production oil activities.

[3] "J.S. App." refers to the Appendix filed by appellants with the Jurisdictional Statement in No. 87-453.

The issue, therefore, is to determine the portion of appellants' income that is attributable to their refining, marketing, and other non-production activities in New Jersey. That is all New Jersey may constitutionally tax.

Where, as here, a taxpayer is engaged in a multistate unitary business, this Court has recognized the difficulty of determining the portion of the taxpayer's income that is attributable to just its activities in the taxing State. In such circumstances, the State is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920). Similarly, in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980), this Court stated:

> . . . separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required. (Citation omitted).

Thus, as this Court noted in *Container Corp. v. Franchise Tax Bd.*, *supra*, it is the theoretical weaknesses of "formal geographical accounting" that "justify resort to formula apportionment." *Container*, *supra*, at 181. Accordingly, for that reason, this Court has upheld the use of formulary apportionment on many occasions. See, e.g., *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980); *Mobil*, *supra*; *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978); *Butler Bros. v. McColgan*, *supra*; *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924); and *Underwood Typewriter Co. v. Chamberlain*, *supra*.

B. In Contrast to Separate Geographical Accounting, Formulary Apportionment Assumes an Equal Rate of Return in All Jurisdictions in Which the Unitary Business Is Conducted.

Under formulary apportionment, the income to be attributed to the taxpayer's activities in the taxing State is determined by apportioning the income of the entire unitary business. The income is ratably divided (on the basis of the apportionment factors employed) between the taxing State and all other jurisdictions in which the unitary business is conducted, so that the taxing State receives the same "rate of return"[4] (on the taxpayer's in-state factors) as is earned by the entire unitary business collectively (on the taxpayer's total factors located everywhere the

[4] The term "rate of return" is used herein as a shorthand way of describing the ratio of income to the apportionment factors employed in producing that income. That term also was used by this Court in *Container*, *supra*, at 183, n. 20. In this case, New Jersey, like most States, uses three, equally weighted apportionment factors—payroll, property, and sales. Thus, in this case, "rate of return" means the ratio of income earned to the payroll, property, and sales producing that income.

unitary business is conducted).[5] Where, as here, the traditional, three-factor apportionment formula is employed, the taxing State will be apportioned a ratable share of the unitary business income based on the average of three ratios (payroll in the taxing State to payroll everywhere, property in the taxing State to property everywhere, and sales in the taxing State to sales everywhere).

In *Container*, such ratable apportionment of the taxpayer's unitary business income, although recognized to be "imperfect", was sustained because of this Court's willingness to accept in that case "the very rough economic assumption that rates of return on property and payroll—as such rates of return would be measured by an ideal accounting method that took all transfers of value into account—are roughly the same in different taxing jurisdictions". *Container*, *supra*, at 183, n. 20.

---

[5] This can be demonstrated mathematically. The basic apportionment formula, using a single payroll, property, and sales ("PPS") factor for simplicity, is:

$$\text{unitary income} \times \frac{\text{state PPS}}{\text{total PPS}} = \text{state income}$$

Mathematically, this is equivalent to:

$$\frac{\text{state PPS}}{\text{total PPS}} = \frac{\text{state income}}{\text{unitary income}}$$

The "rate of return" everywhere will be the same because the foregoing equation can be rewritten:

$$\frac{\text{state income}}{\text{state PPS}} = \frac{\text{unitary income}}{\text{total PPS}}$$

C. Ratable Apportionment Under Formulary Apportionment Results in Extraterritorial Taxation Where the Apportionable Income Base Is Geographically Distorted by Disallowing Out-of-State Costs.

Since formulary apportionment treats each jurisdiction in which the unitary business is conducted as having the same rate of return, formulary apportionment is permissible only where such treatment is warranted. This means that the apportionable income of the business must be determined in a manner that is conceptually consistent with its ratable apportionment to the taxing State. Each of the constituent activities of the unitary business (e.g., exploration, production, refining, etc. in the case of an oil company) must be treated in a consistent manner. Only if this is done will formulary apportionment produce a constitutionally acceptable result, because only then will the apportionment factors fairly measure "the relative contribution of the activities in the [taxing State] to the production of the total unitary income." *Butler Bros.*, *supra* at 509, quoting from the California Supreme Court opinion in that case.

By comparison, if the constituent activities of the unitary business are treated in an inconsistent manner, as occurs when the costs associated with the in-state activities of the unitary business are deducted in full in determining apportionable income while, at the same time, certain costs of out-of-state activities are not deducted, formulary apportionment cannot work properly. Under such circumstances, it is no longer appropriate to assume that such inconsistently determined income is ratably earned in all jurisdictions, and utilization of a formula that assumes a ratable return is no longer justified. By disallowing a deduction for certain costs incurred solely on ac-

count of out-of-state activities, the State is artificially inflating the amount of income derived from those activities. Using such a hybrid definition of apportionable income *necessarily* means that a taxpayer's "rate of return" cannot be the same in all jurisdictions, although formulary apportionment is permissible only when it may fairly be assumed that the rate of return in all jurisdictions is the same. Ratable apportionment is "inherently arbitrary" when the apportionable income base has been determined in a geographically inconsistent manner. *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920). The inevitable result is extraterritorial taxation in violation of the Due Process and Commerce Clauses.

The economic assumption that rates of return are roughly the same in different taxing jurisdictions cannot be made in this case in view of New Jersey's treatment of appellants' out-of-state production activities. In substance, New Jersey is including in apportionable income the *gross* revenue from the out-of-state activities without deductions for all associated costs (oil production income with no WPT) and *net* income from the in-state activities (refining, marketing, and other non-production oil activities with deductions for all associated costs). As New Jersey recognizes (Motion 14),[6] the WPT is a geographically localized cost associated solely with appellants' oil production. The rate of return from oil production when measured on this basis is obviously not comparable with the rate of return from refining, marketing, and other non-production oil activities when measured on

---

[6] "Motion" refers to the Motion to Dismiss or Affirm in No. 87-453.

the basis of net income. Inclusion of the income from the production activities in apportionable income without the allowance of an associated expense, the WPT, thereby makes ratable apportionment inappropriate.

As discussed above, this Court has upheld the constitutionality of formulary apportionment because of the difficulties inherent in separate geographical accounting. Accordingly, for that reason, each State in which a unitary business is conducted is treated as receiving the same rate of return and formulary apportionment is, of necessity, geographically neutral. Against this background, the disallowance of costs on a geographically inconsistent basis is inapporpriate and undermines the integrity of formulary apportionment.

New Jersey's reliance (Motion 14) on *Exxon Corp. v. Wisconsin, supra,* is misplaced. In *Exxon,* this Court merely held that an oil company's out-of-state production activities (which were part of its unitary business) could be taken into account by the taxing State for formulary apportionment purposes. *Amici* do not question that holding. But there is no support whatsoever in that case for treating the out-of-state production activities more onerously than other activities of the unitary business by disallowing costs associated only with those production activities.

Nor is there any merit to New Jersey's apparent suggestion (Motion 17-19) that the apportionable income base may be determined in any fashion whatsoever as long as it does not exceed gross receipts and as long as it is apportioned. New Jersey fails to acknowledge any requirement that the apportionable base, as ultimately determined, be suitable for ratable apportionment. Since the base in this case was geo-

graphically skewed, it is no longer reasonable to assume that it was ratably earned in all jurisdictions. Apportioning appellants' net income from refining, marketing, and other non-production oil activities (the only New Jersey activities) and appellants' pre-WPT income from oil production (non-New Jersey activities) will inevitably result in the taxation by New Jersey of out-of-state values (oil production net income). Contrary to New Jersey's assertion (Motion 14), appellants' burden is not to establish "that something other than income from their integrated petroleum enterprises is being taxed." Appellants need only show that New Jersey is taxing non-New Jersey income. This burden has been satisfied.

Nor is it an answer, as the New Jersey Supreme Court concluded for statutory purposes, that the WPT is a tax "paid or accrued to the United States on or measured by profits or income." Adding back Federal income taxes is perfectly consistent with the theory of formulary apportionment which, as discussed above—

> owes its existence to the fact that with respect to a business earning income through a series of transactions beginning with manufacturing in one State and ending with a sale in another, a precise—or even wholly logical—determination of the State in which any specific portion of the income was earned is impossible. [*Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 286 (1978) (Powell, J., dissenting)]

Since the Federal income tax is imposed on the entire net income of the unitary business, it burdens all activities of the business equally. Thus, adding back

Federal income taxes (or comparable state income taxes) does not disturb the relative apportionment of income to the different locations in which the unitary business is conducted. By comparison, the WPT is imposed only on production activities, without regard to the profitability of the unitary business as a whole. Thus, by adding back the WPT, New Jersey is effectively taxing a portion of the WPT plus the income fairly attributable to appellants' New Jersey activities.

The same point also is easily made by recalling that the imposition of WPT accompanied the phasing out of crude oil price controls. Thus, in effect, the Federal government took back a large portion of the "additional revenue resulting from decontrol." *United States v. Ptasynski*, 462 U.S. 74, 76 (1983). The combined effect of both decontrol and the WPT was only a partial increase in producers' revenues. Yet, New Jersey treats the *full* amount of the WPT as increasing appellants' unitary income and thereby increasing the amount of that income attributed to appellants' New Jersey activities.

II. DISALLOWANCE OF A DEDUCTION FOR THE WPT DISCRIMINATES AGAINST OIL PRODUCERS IN VIOLATION OF THE COMMERCE AND EQUAL PROTECTION CLAUSES.

The disallowance of a deduction for the WPT raises a number of discrimination issues arising under the Commerce and Equal Protection Clauses that are discussed by appellants. Producers of natural resources are particularly vulnerable to discriminatory tax burdens because their production activities are clearly identified with a specific geographic location, and yet the treatment of the costs associated with those activities may be carved out for unfavorable treatment under facially neutral statutes. The *amici*, as pro-

ducers of natural resources, are concerned that the decision of the New Jersey Supreme Court may lead other States to impose discriminatory tax burdens.

By disallowing a deduction for WPT, an oil production cost, New Jersey necessarily discriminates against oil producers who sell their products in New Jersey as contrasted with non-producers who sell similar products in New Jersey. Under the result below, producers are not allowed a deduction for the WPT in determining their apportionable income. By contrast, non-producers who sell their products in New Jersey are allowed a full deduction for their cost of goods sold. As an economic matter, a non-producer's cost of goods sold will always include the wellhead value of the crude oil, because that amount will be included in the price charged by the crude oil producer and passed on to every subsequent purchaser including the consumer. Since the WPT is based on the wellhead value of the oil and is payable out of the producer's wellhead selling price, the non-producer's allowable cost of goods sold deduction necessarily subsumes the dollar amount of the WPT cost that New Jersey disallows as a deduction to the producer. Thus, the producer who sells refined products in New Jersey is denied a deduction that is effectively available to any non-producer selling the same products in New Jersey.

New Jersey acknowledges that producers are discriminated against (Motion 22), but the State offers no justification for singling out this class of interstate taxpayers. The State simply relies (Motion 21-22) on *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117 (1978), as authorizing such discrimination.

This case is far different from *Exxon*. In *Exxon* this Court upheld a Maryland statute that prohibited oil producers or refiners from operating retail service stations within Maryland, concluding (*Exxon*, *supra*, at 125) that the statute bore "a reasonable relation to the State's legitimate purpose in controlling the gasoline retail market." Here, by comparison, producers are permitted to compete with non-producers in the New Jersey refining and marketing of oil products, but only if the producers are willing to bear an economic burden (no deduction for WPT) not imposed on non-producers. New Jersey has made absolutely no attempt to justify this difference in tax treatment. The *amici* believe there is no Constitutional justification for disadvantaging in this manner oil producers engaged in interstate commerce.

CONCLUSION

The decision of the New Jersey Supreme Court should be reversed.

Respectfully Submitted,

WILLIAM L. GOLDMAN*
JAMES A. RIEDY
LEE, TOOMEY & KENT
1200 18th Street, N.W.
Washington, D.C. 20036
(202) 457-8500

**Counsel of Record*